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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation	)	CC Docket No. 92-135

THE REPLY COMMENTS
OF
THE LINCOLN TELEPHONE AND TELEGRAPH COMPANY

The Lincoln Telephone and Telegraph Company ("Lincoln"), by its attorneys, hereby submits its reply comments in the above-captioned proceeding.

I. Introduction

The Commission, on July 17, 1992, released a Notice of Proposed Rulemaking ("NPRM")[1] asking for interested parties to comment on issues related to small and mid-size local exchange carrier ("LEC") regulatory reform. In this reply, Lincoln responds to comments made by various parties in this proceeding.

II. Optional Incentive Regulation Plan

A. Frequency of Filings

Lincoln agrees with American Telephone and Telegraph ("AT&T") that incentive plan carriers ("IPC") should be permitted

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[1] Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135, Notice of Proposed Rulemaking (NPRM), FCC 92-258, Released July 17, 1992.

to adjust rates to the lower earnings band limit if earnings are below the band after one year of a biennial tariff period.[2] This will provide some limited earnings protection and "ensure that the LEC will remain healthy and able to provide needed services. . ."[3]

B. Earnings Band

AT&T supports an earnings band of 100 basis points below the authorized rate of return to 100 basis points above the authorized rate of return[4]. This will not give LECs enough incentive to elect Optional Incentive Regulation ("OIR"). Under OIR, IPCs will face significant risks, comparable to the risks faced by the large price cap carriers. First, IPCs will need to become increasingly more productive, similar to price cap regulation, to derive earnings benefits. The only major difference is that IPCs need to exceed their own historical productivity <u>and inflation</u> rather than the hypothetical industry productivity standard as under price cap regulation. Second, IPCs rates are frozen for two years, whereas price cap carriers receive a yearly inflation adjustment. The use of historical data, a two year rate freeze, and no inflation adjustment will force IPCs to exceed not only their historical productivity but also inflation in both years of a biennial filing, to derive any earnings benefit. Finally,

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[2] See AT&T Comments at 4.

[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6799 (1990) ("Second Report and Order"), modified on recon., 6 FCC Rcd 2637 (1991), petitions for further recon. dismissed, 6 FCC Rcd 7482 (1991).

[4] See AT&T Comments at 3.

because rates are made on historical data, IPCs give productivity gains directly back to the interexchange carriers ("IXC"), while price cap carriers retain a majority of their productivity gains. Based on these risks, a fair earnings band would be 100 basis points below and 200 basis points above the authorized rate of return. Absent a fair earnings band, carriers will not be likely to elect this form of incentive regulation.

AT&T states that any sharing mechanism should require that excess earnings be returned directly to access customers rather than incorporated in future access tariff filings[5]. If any sharing mechanism is needed, direct refunds may be acceptable when coupled with an underearnings[6] adjustment and increased earnings band.

C. Cost Basis for Incentive Plan Tariffs

AT&T, on one hand, argues strongly against the inclusion of known and measurable <u>costs</u> because the inclusion of prospective costs will reduce an IPCs incentive to reduce costs[7]. On the other hand, AT&T argues that the inclusion of prospective carrier common line ("CCL") <u>demand</u> is reasonable and sound[8]. AT&T's arguments are unreasonable and self serving. The inclusion of known and measurable items would allow IPCs to include costs and demand

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[5] <u>See</u> AT&T Comments at 6.

[6] This would be consistent with the sharing mechanism under price caps.

[7] <u>See</u> AT&T Comments at 4.

[8] <u>See</u> AT&T Comments at 8.

changes not reflected in historical data. The rapidly changing environment in which LECs currently operate demands that a carrier invest in new technologies and offer innovative, new services. AT&T seeks to exclude from incentive regulation LECs that aggressively pursue innovation by only allowing equitable cost recovery in baseline rate of return regulation[9]. In addition, AT&T attempts to unfairly bias OIR by arguing for the inclusion of only the prospective items that will benefit the IXCs. If the Commission determines that OIR needs a prospective CCL adjustment, it is only fair to allow IPCs to include any prospective known and measurable item.

D. Derivation of CCL Rates

Lincoln maintains that OIR was fundamentally designed to be an historical plan[10]. As both IXCs and LECs have pointed out, the use of historical data will give IPCs incentives to increase productivity. These increases in productivity, whether through demand increases or cost decreases, will result in lower rates in the next filing. Since all the benefits of demand growth are given back historically to the IXCs in each tariff filing, forcing an IPC

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[9] This assumes that the Commission will recognize the many deficiencies in the current baseline rate of return proposal and allow the current 61.38 rules to remain an option for non-price cap carriers.

[10] An objective OIR plan must allow for significant increases/decreases in cost and demand levels, not reflected in historical trends, to be accounted for in IPC rates. The inclusion of such known and measurable items does not constitute a prospective filing but rather a true-up of the historical data and will give IPCs a fair productivity standard against which to compete.

to also give back the benefit on a prospective basis is patently unfair and confiscatory. If, contrary to the perceived purpose of this plan, the Commission decides to deviate from a historical filing, through the inclusion of prospective demand, prospective costs must also be included. The Commission cannot mix historical and prospective data in a way that will benefit IXCs and harm IPCs.

E. Pricing Flexibility

MCI Telecommunications Corporation ("MCI") states that 10% pricing flexibility over two years is not the same as 5% per year[11]. MCI, however, fails to note that under OIR, pricing flexibility is measured at an element level rather than the basket or service category levels as under price caps. In addition, price increases must be revenue neutral at the basket level. Since pricing flexibility is measured at the element level and price increases must be revenue neutral, 10% pricing flexibility during a two year period is reasonable.

F. Infrastructure and Service Quality Reporting

Lincoln strongly supports Cincinnati Bell Telephone Company's ("CBT") assertion that only service quality reports should be required from IPCs[12]. Carriers for whom price cap regulation is optional are not required to file infrastructure reports. Therefore, since OIR is also an optional plan, IPCs should not be required to file infrastructure reports. In fact,

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[11] See MCI Comments at 4.

[12] See CBT Comments at 14.

the Commission should consider reducing the regulatory burden of non-price cap carriers.

III. Baseline Rate of Return Regulation

In its comments related to baseline rate of return regulation, AT&T supports both biennial filings and the development of prospective costs and demand as simple extrapolations of historical data[13]. This presents a myriad of problems and will very likely cause inaccurate LEC rates[14]. First, simple historical extrapolations usually rely on the assumption that the data being projected is only a function of time. This is very seldom true. Costs and particularly demand levels are the result of the many complex forces existing in today's economy. Data projected as simple historical extrapolations would most likely only be accurate through sheer coincidence. Second, there are many items that need to be forecasted in a prospective tariff filing, most of which defy simple historical extrapolations[15]. Individual account balances, traffic factors, categorization, rules changes, nonrecurring

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[13] See AT&T Comments at 9.

[14] Inaccuracies in LEC rates will ultimately affect all regulatory facets, including monitoring and earnings.

[15] The Commission in its recent tariff review process has used a simple historical trend to evaluate forecasts. Lincoln disputes the validity and accuracy of such trends. The Commission partially mitigated the impact of this type of evaluation through the use of a confidence interval. However, even with an appropriate confidence interval, the use of simple historical trends are only appropriate as tests of reasonableness.

charges, and access demand[16] represent some of the many items that would not fit simple historical extrapolation. In a biennial filing, LECs would need to forecast data for two years instead of one. An accurate one year forecast of econometric variables, expenses, investments, demand, etc., is a difficult enough task. An accurate two year forecast is virtually impossible. Also, errors inherent in nearly all projections would be further magnified in a two year filing[17]. Finally, historical trends do not represent the investments that will be made by LECs in innovative, new technologies and services. Baseline rate of return represents a fallback position for LECs that cannot meet the productivity demands of the various incentive plans. So the Commission must ensure that LECs are allowed to accurately reflect prospective costs and demand levels. Therefore, under baseline rate of return regulation, LECs must retain the option of

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[16] The simple historical trend line analysis performed by the Commission in recent tariff filings has shown carrier common line minutes exceeding traffic sensitive minutes for some LECs. In actuality there is no way carrier common line minutes can ever exceed traffic sensitive minutes because traffic sensitive minutes are the sum of carrier common line and WATS minutes. The fact that the sharp decline in WATS minutes, experienced by many LECs, is not compensated for in a simple historical extrapolation causes this inaccuracy. This is one of many problems that may be caused by the use of simple historical extrapolations. See 1992 Annual Access Tariff Filings, CC Docket No. 92-141, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, DA 92-841, Released June 22, 1992, Appendix C.

[17] Actual data nearly always deviates from projections. These deviations, from the minor discrepancies in statistically sound econometric models to the major errors likely resulting from simple historical extrapolations, will all be further magnified by increasing the projection period.

forecasting costs and demand on a true prospective basis for a one year period. In addition, the rates developed using this prospective data should only be required to remain effective for one year. To require biennial filings based on simple historical extrapolations is not a reasonable means of reducing regulatory burden and may result in harm to LECs.

IV. Conclusion

Lincoln feels strongly that OIR should be a historical plan. The use of historical data in ratemaking, results in all demand benefits being returned to the IXCs. To require IPCs to give back the benefit of demand growth historically and prospectively is confiscatory. If the Commission determines that OIR is not to be a historical plan, then OIR should not incorporate only the prospective items that will benefit the IXCs. If prospective demand is required to be reflected in filings, IPCs should be allowed to reflect any known and measurable item.

In addition, to ensure equitable cost recovery and accurate rates, baseline rate of return LECs must be able to make true prospective filings, effective for one year, using one year of projected data. Simple historical extrapolations are usually inaccurate and would not represent the rapidly changing telecommunications environment. In addition, two year forecasts will magnify the model errors that are inherent in even the best projections. The inaccuracies that would be caused by these changes far outweigh any regulatory savings that may be gained.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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